Current Trends in the Administration of International Transfer Pricing by the Internal Revenue Service

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September 15, 2003

MEMORANDUM FOR COMMISSIONER EVERSON

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SUBJECT: Final Audit Report - Current Trends in the Administration of International Transfer Pricing by the Internal Revenue Service (Audit # 200230038)

This report presents the results of our review of international transfer pricing. The overall objective of this review was to determine the current trends in the administration of international transfer pricing by the Internal Revenue Service (IRS). Transfer pricing is among the most important and complex international tax issues faced by large Multinational Enterprises (MNE)[1] and the IRS.

In summary, international transfer pricing is a term commonly used to describe pricing arrangements for exchanging goods, services, and other property between related entities or affiliates with operations in the United States (U.S.) and in other countries. International transfer prices are significant for both MNE taxpayers and tax administrators because transfer pricing determines in large part the taxable profits of related enterprises in different tax jurisdictions. Therefore, a natural conflict exists between governments and MNEs. The governments seek to ensure that profits earned within their borders are taxed, and the MNEs seek to minimize their worldwide tax liabilities.

These intercompany or "controlled transactions" across borders are increasing as MNEs continue to globalize their operations. The Department of Commerce reported for Calendar Year 2001 that related-party merchandise trade accounted for $526 billion

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[1] An MNE group is a group of associated companies with business establishments in two or more countries. These companies may be any form of business entity including corporations, partnerships, and sole proprietorships.

(46 percent) of the $1.133 trillion in U.S. imports, and $223 billion (31 percent) of the $731 billion in U.S. exports.[2] Since 1990, imports have increased by 128 percent while exports have increased 89 percent.

With so much potential tax at risk, governments have various means to ensure that MNE taxpayers comply with their tax laws. In the U.S., Internal Revenue Code (I.R.C.) Section (§) 482[3] gives the IRS the authority to allocate income, expenses, and credits between related entities. When making these allocations, the IRS uses the "arm's length" standard.[4] In a 1999 study,[5] the IRS tentatively estimated the loss due to transfer pricing at $2.8 billion in income taxes. An ongoing study being prepared for the Congress estimates that the use of inflated and undervalued transfer prices by MNE groups allowed them to avoid paying $53 billion in U.S. income taxes in Tax Year (TY) 2001. However, comprehensive and reliable compliance data do not exist; therefore, estimates of the tax gap due to transfer pricing should be considered tentative.

The determination of whether MNE taxpayers are paying the proper tax does not come without cost to both the IRS and the MNE taxpayers. According to available IRS cost data and estimates, which are incomplete, approximately $22 million was expended on transfer pricing administration in Fiscal Year (FY) 2002. For MNE taxpayers, the cost can be $100,000 to over $1 million for preparing contemporaneous transfer pricing documentation needed to avoid penalties.

The tax administration for international transfer pricing is continuing to evolve as cross-border transactions increase. Since 1992, the IRS has implemented a five-part approach aimed at shifting the focus from after-the-fact examination and litigation of transfer pricing controversies, to encouragement of upfront taxpayer compliance and advance resolution of transfer pricing issues. As part of this strategy, the IRS administers transfer pricing issues through several pre- and post-filing activities for the 47,716 MNE taxpayers[6] reporting controlled transactions in TY 2000.

The IRS' two primary transfer pricing pre-filing activities are publication and guidance and the Advance Pricing Agreement (APA) Program. The goal of the publication and guidance activity is the continuing refinement of the transfer pricing regulations to explain the compliance requirements. The regulations have continued to evolve since

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[2] U.S. Department of Commerce, Bureau of the Census, *U.S. Goods Trade: Imports and Exports by Related Parties;* 2001.

[3] I.R.C. § 482 (2003).

[4] The goal of the "arm's length" standard is to distribute income in the same manner as the market would distribute income; therefore, related parties should earn the same return that unrelated parties would earn under similar circumstances. This involves determining what the transfer price would be on a transaction basis if the parties were unrelated and the transactions uncontrolled.

[5] U.S. Department of the Treasury, IRS, *Report on the Application and Administration of Section 482;* 1999.

[6] The number represents the sum of U.S. entities filing one or more Information Return of U.S. Persons With Respect To Certain Foreign Corporations (Form 5471) reflecting cross-border transactions, and the number of U.S. entities reflecting foreign ownership through the filing of one or more Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (Form 5472). Some double counting may occur since some filers are required to file both Forms 5471 and 5472.

1935, when the “arm’s length” standard was first defined, and were extensively revised in 1994. While the effect that IRS guidance has on transfer pricing compliance has not been determined, tax administrators believe that the guidance has a significant effect on voluntary compliance. The second pre-filing activity is the APA Program. This Program, which started in 1991, continues to grow. From inception through December 31, 2002, a total of 452 APAs were executed. The number of APAs executed annually increased from only a few in the early years to an average of 74 in recent years. The taxpayers that participate in the APA Program are some of the largest MNEs.

The IRS post-filing transfer pricing activities include four interrelated activities. The first activity is the Examination Program. In FY 2002, the IRS recommended $5.56 billion[7] in transfer pricing adjustments. This was a 34 percent increase from FY 1997, when the IRS recommended $4.16 billion in transfer pricing adjustments.

When taxpayers do not agree with the adjustment, there are two subsequent resolution processes. The first subsequent resolution activity is to protest the transfer pricing adjustment to the Office of Appeals where it can be conceded in full or substantially reduced. In FY 2002, the Office of Appeals’ data system tracked $899 million in recommended transfer pricing adjustments that were subsequently reduced to $157.4 million due to hazards of litigation (i.e., the risk of losing the issue in court) or because information needed to support the adjustments was not considered adequate in the judgment of the Office of Appeals. The second subsequent resolution activity is for the taxpayer to petition the U.S. Tax Court prior to paying the tax or to pay a disputed tax, file a claim for refund, and when it is disallowed (or more than 6 months has elapsed without action by the IRS), initiate a suit in a U.S. District Court or in the Court of Federal Claims.

A procedure parallel to the transfer pricing activities exists to ensure that MNE taxpayers are not burdened by double taxation. MNE taxpayers may request the assistance of the U.S. Competent Authority for the relief from double taxation through an international dispute resolution process called the Mutual Agreement Procedure.

This report contains no recommendations. The purpose of the report is to identify trends in transfer pricing tax administration. We discussed the issues contained in the report with appropriate IRS executives and have incorporated their viewpoints into this report.

Copies of this report are also being sent to the IRS managers who are affected by the report issues. Please contact me at (202) 622-6510 if you have questions, or your staff may call Parker F. Pearson, Director (Small Business Compliance), at (410) 962-9637.

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[7] Source: International Case Management System.

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Background

International transfer pricing is a term commonly used to describe pricing arrangements for exchanging goods, services, and other property between related entities or affiliates[1] of a Multinational Enterprise (MNE) group[2] with operations in the United States (U.S.) and in other countries. International transfer prices are significant for both MNE taxpayers and tax administrators, because transfer pricing determines in large part the taxable profits of related entities in different tax jurisdictions. Therefore, a natural conflict exists between governments and MNEs. The governments seek to ensure that profits earned within their borders are taxed, and the MNEs seek to minimize their worldwide tax liabilities.

These intercompany or "controlled transactions" across borders are increasing as MNEs continue to globalize their operations, and they represent a significant and growing tax administration challenge to the U.S. and its global trading partners. The Department of Commerce reported for Calendar Year (CY) 2001 that related-party merchandise trade accounted for $526 billion (46 percent) of the $1.133 trillion in U.S. imports, and $223 billion (31 percent) of the $731 billion in U.S. exports.[3] Since 1990, imports have increased 128 percent, from $498 billion, while exports have increased 89 percent, from $387 billion.[4]

The challenge to tax administrators is to determine whether the allocation of income and expenses is done at the "arm's

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[1] Related entities or affiliates and other important tax concepts are explained in Appendix IV.
[2] An MNE group is a group of associated companies with business establishments in two or more countries. These companies may be any form of business entity including corporations, partnerships, and sole proprietorships.
[3] U.S. Department of Commerce, Bureau of the Census, *U.S. Goods Trade: Imports and Exports by Related Parties; 2001*.
[4] See Appendix VIII for additional information describing how globalization is leading to an increase in the number of controlled transactions.

length" standard.[5] The challenge to the MNE is to minimize its worldwide tax liability. When tax is minimized through improper transfer pricing methods, income shifts to low tax or no tax jurisdictions and expenses shift to high tax jurisdictions.

The following hypothetical example shows how transfer pricing shifts can alter profits and reduce taxes:

> A parent company residing in the U.S. purchases widgets from its wholly owned subsidiary in Country M. The parent company agrees to purchase 10,000 widgets from its subsidiary at $35 above the market price. This increases the parent's expenses by $350,000 and lowers its U.S. taxable income by $350,000, while increasing the subsidiary's profits by $350,000. With a 35 percent income tax rate in the U.S., the parent company avoids $122,500 in U.S. income taxes, while the subsidiary pays $35,000 in Country M income taxes based on a 10 percent income tax rate, saving $87,500 in worldwide income taxes.

A more comprehensive scenario is provided in Appendix V.

With so much potential tax at risk, governments have various means to ensure that MNE taxpayers comply with their tax laws. In the U.S., Internal Revenue Code (I.R.C.) Section (§) 482[6] gives the Internal Revenue Service (IRS) the authority to allocate income, expenses, and credits between related entities. When making these allocations, the IRS uses the "arm's length" standard. The "arm's length" standard was developed by the courts and first defined in the Treasury Regulations in 1935.[7]

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[5] The goal of the "arm's length" standard is to distribute income in the same manner as the market would distribute income; therefore, related parties should earn the same return that unrelated parties would earn under similar circumstances. This involves determining what the transfer price would be on a transaction basis if the parties were unrelated and the transactions uncontrolled.
[6] See Appendix XII for the text of I.R.C. § 482.
[7] See Appendix VI for historical and background information on I.R.C. § 482 and the "arm's length" standard.

There is a concern that transfer pricing is a continuing tax compliance risk area; however, comprehensive and reliable compliance data do not exist. Therefore, estimates of the tax gap due to transfer pricing should be considered tentative and subject to substantial revisions when better data become available. In a 1999 study,[8] the IRS tentatively estimated the loss due to transfer pricing at $2.8 billion.[9] An ongoing academic study[10] being prepared for the Congress estimates that the use of inflated and undervalued transfer prices by MNE groups allowed them to avoid paying

[8] U.S. Department of the Treasury, IRS, *Report on the Application and Administration of Section 482*; 1999.

[9] The $2.8 billion dollar income tax estimate was arrived at using adjustments to income from IRS International Examiner operational examinations of U.S. Corporation Income Tax Returns (Form 1120) completed during Fiscal Years 1996 through 1998. The following steps were used to determine the estimate: (1) transfer pricing income adjustment amounts were summed by industry group, asset class size, and type of corporation for each of the 3 fiscal years; (2) transfer pricing income adjustment sums were expanded to the total population using separate expansion ratios for the 3 sizes of corporations based on asset class; (3) the expanded income adjustment amounts were converted to tax gap estimates by applying an average marginal corporate income tax rate of 34 percent; and (4) the overall tax gap estimate was computed by taking the average for the 3 years.

[10] *U.S. Trade with the World: An Estimate of 2001 Lost U.S. Federal Income Tax Revenues Due To Over-Invoiced and Under-Invoiced Exports*, by Professors Simon J. Pak, Ph.D. of Penn State University – Great Valley, and John S. Zdanowicz, Ph.D. of Florida International University.

$53 billion[11] in U.S. income taxes in Tax Year (TY) 2001.[12] The two estimates are arrived at using vastly different techniques. Neither takes into account how prior year corporate losses, tax credits, or other tax return factors might interact to reduce or eliminate the estimated tax losses due to improperly valued transfer pricing. While the true tax loss to the Treasury due to transfer pricing may never be known, it must also be placed in the proper context of the nearly $2 trillion in annual U.S. trade.

This audit was part of our Fiscal Year (FY) 2003 emphasis on the Large and Mid-Size Business (LMSB) Division's strategic initiatives. The audit was performed in accordance with *Government Auditing Standards* between August 2002 and February 2003. Onsite work was performed in the LMSB Division's Headquarters in Washington, D.C. This report contains no recommendations. Its purpose is to identify trends in transfer pricing tax administration.

Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

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[11] The $53 billion dollar estimate was arrived at using U.S. import and export data contained in the U.S. Merchandise trade database produced by the U.S. Department of Commerce, Bureau of the Census. The following steps were used to determine the estimate: (1) determined the median price, lower quartile export price, and upper quartile import price for every commodity exported and imported; (2) evaluated every import record, compared it to the country-specific import upper quartile price to determine if it was overvalued, and determined the dollar value of overvaluation for every import transaction; (3) evaluated every export record, compared it to the country-specific export lower quartile price to determine if it was undervalued, and determined the dollar value undervaluation for every export transaction; (4) determined the dollar value impact on the cost of goods sold due to the overvaluation for every import transaction and determined the dollar value impact on sales revenue due to undervaluation for every export transaction; and (5) calculated the tax loss for every transaction assuming a 34 percent marginal tax rate.

[12] Jim Abrams, "Corporate Tax Avoidance Chronicled," *Associated Press*, November 1, 2002.

Transfer Pricing Trends Show Increasing Challenges for the Internal Revenue Service and Multinational Enterprises

The tax administration challenges presented by transfer pricing issues are significant for the IRS. I.R.C. § 482 regulations are complex, and proposed adjustments are regularly challenged by MNEs. At the same time, there is concern about the potential compliance gap widening as MNEs continue to globalize their operations.

The IRS' goal in administering I.R.C. § 482 is to ensure that each controlled taxpayer reflects its true taxable income from intercompany transactions as determined under the "arm's length" standard. Since 1992, the IRS has implemented a five-part approach aimed at shifting the focus from after-the-fact examination and litigation of transfer pricing controversies, to encouragement of upfront taxpayer compliance and advance resolution of transfer pricing issues. The five-part approach includes:

* Issuing guidance on the application of the "arm's length" standard.
* Promulgating contemporaneous documentation legislation and issuing related guidance.
* Working to build worldwide consensus on the application of the "arm's length" standard through the Organization for Economic Cooperation and Development and other international groups.
* Encouraging taxpayers to use the Advance Pricing Agreement (APA) Program.
* Developing procedures to coordinate technical and legal support in I.R.C. § 482 matters.

The IRS administers transfer pricing issues through several pre- and post-filing activities for the 47,716 MNE taxpayers[13] reporting controlled transactions in TY 2000. In

[13] The number represents the sum of U.S. entities filing one or more Information Return of U.S. Persons With Respect To Certain Foreign Corporations (Form 5471) reflecting cross-border transactions, and the number of U.S. entities reflecting foreign ownership through the filing of one or more Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (Form 5472). Some double counting may occur since some filers are required to file both Forms 5471 and 5472.

total, tax administration activities cost the IRS a minimum of $22 million in FY 2002. Following are descriptions of tax administration trends for transfer pricing and the associated costs, to the extent available, to the IRS in administering transfer pricing compliance issues and to MNE taxpayers in complying with the transfer pricing regulations under I.R.C. § 482.[14]

Pre-filing transfer pricing activities

The IRS' two primary pre-filing activities in administering transfer pricing are publication and guidance, and the APA Program. Publication and guidance is targeted at a broad spectrum of taxpayers, and the APAs apply to individual MNE taxpayer situations. These activities are both controlled by the Office of Associate Chief Counsel (International) (ACCI), a component of the Office of Chief Counsel.

The goal of the publication and guidance activity is the continuing refinement of transfer pricing regulations to explain the compliance requirements. The regulations have continued to evolve since 1935, when the "arm's length" standard was first defined. Recently, the IRS published regulations clarifying the treatment of stock options as a cost under the cost-sharing regulations. The IRS is also working on the last part of the larger regulation project, started in the late 1980s, to update the 1968 I.R.C. § 482 regulations by clarifying the rules on the treatment of services, as well as a project updating the 1995 cost-sharing regulations.

The transfer pricing regulations require the MNE taxpayer to select the most appropriate transfer pricing methodology from the various methods described in the regulations. The method selected should provide the most accurate measure of the "arm's length" result under the facts and circumstances of the transaction. The transfer pricing regulations also encourage the MNE taxpayer to document, at the time the return is filed, the transfer pricing

[14] See Appendix VII for additional information concerning IRS initiatives currently underway to help improve voluntary compliance and the administration of transfer pricing.

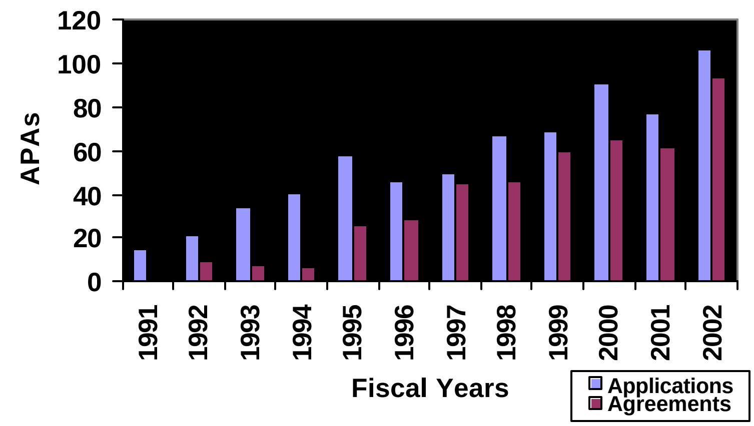
methodology selected, the reasons for its selection, the methods rejected, and the reasons for rejection. If the documentation rules are satisfied, taxpayers can protect themselves from transfer pricing penalties that would otherwise apply.

In FY 2002, ACCI attorneys spent 2,027 hours revising the transfer pricing regulations, at an estimated cost of approximately $110,000. While the effect that IRS guidance has on transfer pricing compliance has not been determined, tax administrators believe that the guidance has a significant effect on voluntary compliance.

The second pre-filing activity is the APA Program.[15] The APA Program is a voluntary and cooperative process that enables MNE taxpayers to enter into prospective agreements with the IRS to achieve certainty regarding the tax results of their transfer pricing for cross-border transactions. The taxpayers that participate in the APA Program are some of the largest MNEs. This Program, which started in 1991, continues to grow. From inception through December 31, 2002, a total of 452 APAs were executed. The number of APAs executed annually increased from only a few in the early years to an average of 74 in recent years. The APA Program has received 676 applications since it began in 1991.

[15] See Appendix X for additional information concerning APA Program trends.

Figure 1: APA Applications and New and Renewed Agreements (FYs 1991 - 2002)



Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of APA Program Annual Reports to the Congress.

APAs come in two forms: a bilateral agreement and a unilateral agreement. A bilateral APA generally combines an agreement between a taxpayer and the IRS on an appropriate transfer pricing methodology for the transactions at issue, with an agreement between the U.S. and one or more foreign tax authorities that the transfer pricing methodology is correct. With a bilateral APA, the IRS and the foreign tax authority assure the taxpayer that the income associated by the covered controlled transaction will not be subject to double taxation. There have been 224 bilateral and 7 multilateral[16] APAs.

A unilateral APA is an agreement between a taxpayer and the IRS establishing an approved transfer pricing methodology for U.S. tax purposes only. A unilateral APA binds the taxpayer and the IRS but does not prevent foreign tax administrations from taking a different position on the appropriate transfer pricing methodology for a controlled transaction. There have been 221 unilateral APAs.

Obtaining an APA involves both time and a monetary commitment. Filing an APA request requires a user fee that can range between $5,000 and $25,000 and preparation of a

[16] A multilateral APA is essentially a bilateral APA between the U.S. and two or more foreign tax authorities.

transfer pricing study tailored to the taxpayer's cross-border transaction. As discussed later, the price of these studies varies but can reach upwards of $1 million or more.

In FY 2002, the APA Program reported that it took an average of 24.6 months to complete a new bilateral APA and an average of 21 months to complete a new unilateral APA. In our discussions with the IRS concerning this report, the APA Program staff reported that the time to complete APA requests has improved in the past few years since staffing increases have reduced inventory backlogs (see Table 1).

Table 1: Average Number of Months a Case Is in Inventory

	Bilateral Inventory[17]	**Unilateral Inventory**
	Number of Months in Inventory	
June 30, 2000	15	13
June 30, 2001	18	14
June 30, 2002	11	12[18]

Source: The APA Program.

The APA Program itself still represents a commitment in terms of cost, time, and providing the IRS access to sensitive, proprietary information that can create uncertainty for MNE taxpayers until the Agreement is completed. Some of the costs in connection with an APA are the APA request submission, requests for additional information, and meetings. However, through an APA, MNE taxpayers may achieve certainty for the duration of the prospective multiyear term of the APA, and that resolution may be carried back where appropriate to previously filed years that may be under examination through a rollback. By contrast,

[17] This number reflects the average number of months for all bilateral cases that have not been forwarded to the U.S. Competent Authority for a Mutual Agreement.
[18] This 12-month number was calculated by excluding 5 banking cases that had been included in bilateral inventory for several years. June 30, 2002, is the first time the banking cases are reflected as unilateral inventory. The banking cases are excluded for the purpose of determining the average number of months because of their unusual case history.

resolution of disputes that grow out of an examination may take more than 8 years to resolve.

In FY 2002, the Office of Chief Counsel incurred costs of approximately $4.3 million in administrating the APA Program.

Post-filing transfer pricing activities

There are four interrelated IRS post-filing transfer pricing activities. The first activity is the Examination Program.[19] The IRS attempts to assure voluntary compliance with the transfer pricing regulations by using highly trained specialists to conduct post-filing examinations of income tax returns that contain controlled transactions. The primary objective in selecting returns for examination is to promote the highest degree of voluntary compliance on the part of taxpayers.[20] In FY 2002, the IRS recommended $5.56 billion[21] in transfer pricing adjustments. This was a 34 percent increase from FY 1997, when the IRS recommended $4.16 billion in transfer pricing adjustments. From available IRS cost information, we estimate that the direct examination costs were at least $15 million.[22]

When taxpayers do not agree with the adjustment, there are two subsequent resolution processes. The first subsequent resolution activity is to protest the transfer pricing adjustment to the Office of Appeals. An Appeals Officer or

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[19] See Appendix IX for additional information concerning transfer pricing examination trends.

[20] Internal Revenue Manual (IRM) 1.2.1 Part 4 P-4-21 (2000).

[21] Source: International Case Management System (ICMS).

[22] The IRS also spends approximately $311,000 for 3 transfer pricing subject matter experts as part of its international technical specialist program. These experts provide both formal and informal assistance to tax examiners in the form of continuing professional education, written examination techniques and guidelines, and documents outlining the IRS' position on tax issues. They also provide assistance to the ACCI by providing advice on the development of new regulations, rulings, procedures, tax forms, and APAs. For additional information on the international technical specialist, see the TIGTA audit report *Opportunities Exist to Enhance the International Field Assistance Specialization Program* (Reference Number 2000-30-130, dated September 2000).

an Appeals Team will evaluate the facts and circumstances surrounding the tax issues and attempt to resolve the case.

In FY 2002, the Office of Appeals' data system tracked $899 million in recommended transfer pricing adjustments that were subsequently reduced to $157.4 million due to hazards of litigation (i.e., the risk of losing the issue in court) or because information needed to support the adjustments was not considered adequate in the judgment of the Office of Appeals.

The number of closed returns with transfer pricing issues tracked[23] by the Office of Appeals increased from 94 returns in FY 2000 to 97 returns in FY 2002. Our analysis shows that approximately 30 percent of the 1,078 returns with transfer pricing adjustments closed by international specialists in FY 1997 were settled by the Office of Appeals.[24] The Office of Appeals has no management information to determine the costs associated with settling transfer pricing cases. We did not attempt to estimate these costs.

The second subsequent resolution activity is litigation. In this activity, the taxpayer may petition the U.S. Tax Court prior to paying the tax or pay a disputed tax, file a claim for refund, and when it is disallowed (or more than 6 months has elapsed without action by the IRS), initiate a suit in a U.S. District Court or in the Court of Federal Claims. The Office of Chief Counsel has no available summary data regarding resolution of I.R.C. § 482 cases. The Office of Chief Counsel until recently had no ability to identify the specific provision of the I.R.C. at issue in a specific case in litigation, and there is no requirement that the amounts of specific adjustments be recorded in the databases.

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[23] The Office of Appeals' Case and Issue Reports System is used to track the five most significant issues on all Coordinated Industry Cases (CIC) and industry specialization program issues or Appeals-coordinated issues on selected Non-CICs.

[24] To gain a better understanding of the final disposition of income tax return examinations with transfer pricing issues, we successfully matched 1,078 returns out of 1,083 returns with identified transfer pricing activity on the ICMS with the closed Audit Information Management System data for FYs 1997 through 2002.

However, in a 1999 study, the IRS described the importance of litigation as a tool in the administration of I.R.C. § 482 cases:

> *Because these cases typically revolve around complex factual valuation issues, they require the devotion of enormous amount of resources on the part of the IRS, the courts, and the taxpayers. …Nevertheless, the cost of litigation cannot be a controlling factor when deciding whether to litigate. Otherwise, tactical delay in producing information until a case has reached the Court should yield enormous advantage to uncooperative taxpayers. Several recent cases illustrate the difficulty faced by the IRS in determining an appropriate reallocation and defending such reallocation when information is not forthcoming until after a controversy reaches court. Although the reallocations sustained by the Court were greatly reduced from those initially determined by the IRS, substantial adjustments to the position taken on the return were sustained nevertheless.*[25]

This litigation does not come without cost. In the same study, the IRS described the costs of preparing and litigating two I.R.C. § 482 cases. The cost of 1 case was over $4.6 million, and the cost of the other case was over $2 million.

A procedure parallel to the transfer pricing activities exists to ensure that MNE taxpayers are not burdened by double taxation. MNE taxpayers may request the assistance of the U.S. Competent Authority for the relief from double taxation when a disputed transaction involves the taxing jurisdictions of the U.S. and one or more of its treaty partners through an international dispute resolution process called the Mutual Agreement Procedure (MAP). In the U.S., the MAP process is performed by the LMSB Division's Office of the Director, International, who is the U.S. Competent Authority for all tax treaty matters. When a

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[25] U.S. Department of the Treasury, IRS, *Report on the Application and Administration of Section 482*; 1999.

transfer pricing adjustment is made during an examination on a related entity that is under the jurisdiction of a U.S. treaty partner, the taxpayer has the option of invoking Revenue Procedure 2002-52[26] to secure relief from double taxation.[27]

In the MAP process, the competent authorities of the U.S. and the treaty partner meet in an effort to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of a tax treaty. With respect to transfer pricing issues, the goal of the MAP process is avoidance of double taxation or taxation not in accordance with the applicable treaty. The U.S. Competent Authority reported that, in FY 2002, the MAP process eliminated potential double taxation in 92 percent of the adjustments (by providing correlative relief[28] 38 percent of the time, withdrawing the adjustment 27 percent of the time, and providing partial relief through foreign tax credit 27 percent of the time).

Between FYs 1997 and 2002, the U.S. Competent Authority reported no clear trends with regard to the length of the MAP process. Depending upon the year, the length of the process averaged 679 days to 948 days. During the same period, the U.S. Competent Authority also reported that it can take up to 484 days on average to secure a Mutual Agreement, depending upon the year a bilateral APA case was closed.[29] Though the MAP process can run concurrently with an ongoing examination or appeal in

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[26] Rev. Proc. 2002-52, IRB 2002-31, 242.

[27] Double taxation occurs when an allocation is made under I.R.C. § 482, or an equivalent provision under the laws of a treaty country, on income that was previously taxed. For example, if the IRS reallocates $350,000 in cost of goods sold from the U.S. parent to its foreign subsidiary, it reduces the taxable income of the foreign subsidiary and increases the taxable income of the parent corporation. The $350,000 allocation would now be subject to tax by both the U.S. and the foreign tax jurisdiction.

[28] Correlative adjustment is an adjustment that creates a corresponding decrease in the income of another member of the group of controlled taxpayers. IRM 4.60.3.3.1 (2002).

[29] See Appendix XI for additional trend information on the U.S. Competent Authority, the MAP process, and their relationship to transfer pricing.

consideration of an issue, in some cases it can present a potential delay to the completion of transfer pricing examination cases, Office of Appeals cases, and APA cases that involve U.S. treaty partners. In FY 2002, the MAP process cost approximately $1.8 million related to the administration of transfer pricing.

MNE taxpayers can incur substantial costs to document transfer pricing methods

In Ernst & Young surveys of international tax issues, transfer pricing ranks as the number one concern of MNE tax managers. One reason is that MNE taxpayers can protect themselves from significant transfer pricing penalties by satisfying the transfer pricing documentation rules. Under I.R.C. § 6662(e),[30] an MNE can avoid penalties associated with an examination transfer pricing allocation if it provides contemporaneous transfer pricing documentation within 30 days after the IRS requests it. Failure to maintain and provide the documentation timely can result in penalties for the MNE of up to 40 percent of the tax deficiency.

The costs to prepare the transfer pricing documentation can appear quite substantial, but need to be evaluated in the context of the IRS' upfront compliance effort in the administration of the transfer pricing process. In 2001, the IRS commissioned a study[31] of 1,529 MNE taxpayers and received substantially complete responses from 696. From a sampling of 567 responses, 176 (31 percent) showed that the respondents were spending from $100,000 to over $1 million preparing the required contemporaneous transfer pricing documentation (see Table 2). In a response to a discussion draft of this report, the Office of Chief Counsel commented that $1 million spent on transfer pricing documentation by a taxpayer that has over $1 billion in

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[30] I.R.C. § 6662(e) (2003).

[31] *Fiscal Years 2000-2001 IRS Study: Effectiveness of Internal Revenue Code Section 6662(e)* (dated December 28, 2001). The data from the survey in the report represent responses collected by the independent market research firm of Schulman, Ronca, & Bucuvalas, Inc. under contract to the IRS. The data reflected in the table represent unconfirmed taxpayer claims in answer to the survey questionnaire.

annual gross receipts may be relatively inexpensive considering the taxpayer's total gross receipts and the potential costs and hazards of the examination, appeals, and litigation processes.

Table 2: Amount Spent on Preparing Transfer Pricing Documentation

	Gross Receipts						
Amount Spent	**$10-$61 Mil.**	**$62-$124 Mil.**	**$125-$249 Mil.**	**$250-$499 Mil.**	**$500 Mil. - $1 Bil.**	**Over $1 Bil**	**Total**
Sample Size	N=27	N=58	N=68	N=101	N=80	N=233	N=567
$0	11%	7%	7%	3%	3%	3%	4%
$1 to $100,000	56%	64%	63%	66%	63%	37%	53%
$100,001 to $200,000	4%	10%	12%	13%	18%	18%	15%
$200,001 to $500,000	7%	-%	3%	8%	6%	23%	12%
$500,001 to $1 Mil.	-%	-%	-%	-%	1%	6%	3%
More than $1 Mil.	-%	-%	-%	-%	-%	2%	1%
Declined to Comment	22%	19%	15%	10%	10%	12%	13%

Source: IRS data.[32]

The same survey found that 60 percent of the MNE taxpayers were committing the resources of 1 to 10 full-time employees for handling transfer pricing issues and documentation. The survey also reported that MNE taxpayers spent over 18 percent of their total annual tax

[32] The data in the table represent responses collected in a survey conducted by the independent market research firm of Schulman, Ronca, & Bucuvalas, Inc. under contract to the IRS. The data reflected in the table represent unconfirmed taxpayer claims in answer to the survey questionnaire. Some columns in the table total to 101 percent due to rounding.

compliance budgets to address transfer pricing issues. In discussions about this audit report, the IRS officials responsible for transfer pricing issues stated that while MNE transfer pricing contemporaneous documentation costs can appear very significant, the costs need to be viewed in the overall context of encouraging upfront compliance with the transfer pricing regulations.

As MNEs continue to expand their global operations, the costs to document the controlled transactions are likely to continue to increase. Beyond this, different nations can require different documentation. While there is some agreement among nations on documentation standards, differences do exist. These differences add to the MNEs' documentation costs.

Conclusion

The tax administration challenges for international transfer pricing will continue as globalization continues. The transfer pricing compliance approaches in place are evolving processes to address transfer pricing in a comprehensive manner that benefits both the IRS and MNEs.

Appendix I

Detailed Objective, Scope, and Methodology

The objective of the review was to determine the current trends in the administration of international transfer pricing by the Internal Revenue Service (IRS). Onsite tests were performed in the Large and Mid-Size Business (LMSB) Division Headquarters. Information was obtained from the LMSB Division, the Office of Appeals, and the Office of Associate Chief Counsel (International).

To achieve the audit objective, we extensively relied on internal management reports and computer-processed data contained in the Foreign Information System (FIS), International Case Management System (ICMS), Audit Information Management System, Appeals Centralized Data System (ACDS), and Case and Issue Reports System (CIRS). We did not establish the reliability of these data because extensive data validation tests were outside the scope of this audit. The specific tests included the following:

I. Using IRS information systems and reports, determined the trends in the administration of international transfer pricing under Internal Revenue Code (I.R.C.) Section (§) 482.[1]

   A. Using the FIS database for Tax Years 1996 through 2000, determined the number of Information Returns of U.S. Persons With Respect To Certain Foreign Corporations (Form 5471) and Information Returns of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (Form 5472) filed, the number of entities filing these forms, and the categories and amounts of controlled transactions reported.

   B. Using extracts of the closed cases from the ICMS database for Fiscal Years (FY) 1997 through 2002, determined the total number of returns, cases, issues, and length of international examination for Coordinated Industry Cases (CIC) and Non-CICs containing I.R.C. § 482 transfer pricing issues conducted by International Examiner Revenue Agents for each fiscal year.

   C. Using the Coordinated Examination Management Information System database for FYs 1997 through 2001, determined the total number of returns, cases, issues, and length of examination for CICs having I.R.C. § 482 transfer pricing issues for each fiscal year.

[1] I.R.C. § 482 (2003).

D. Using the ACDS/CIRS database for FYs 2000 through 2002, determined the total number of returns, cases, issues, average length of appeals, amount of recommended examination adjustments, amount of the sustained Office of Appeals adjustment, and sustention rate for each fiscal year.

E. Reviewed and analyzed reports from the Office of Chief Counsel concerning its transfer pricing activities for FYs 1997 through 2002 derived from the Counsel Automated System Environment and Counsel Automated Tracking System for trends in the administration of transfer pricing.

F. Reviewed and analyzed tables made available by the United States Competent Authority on the IRS web site describing its activities in the Mutual Agreement Procedure process to determine program trends.

G. Reviewed and analyzed the Advance Pricing Agreement (APA) Program annual reports submitted to the Congress for Program trends.

II. Reviewed criteria associated with the administration of international transfer pricing under I.R.C. § 482.

A. Reviewed I.R.C. §§ 482 and 6662(e)[2] along with the associated regulations, revenue procedures, and internal operating procedures found in the Internal Revenue Manual.

B. Reviewed and analyzed the model tax conventions of the United Nations and the Organization of Economic Cooperation and Development (OECD) for provisions specifying use of the "arm's length" standard. We also reviewed and analyzed the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (dated July 1995).

C. Reviewed the mission statements, performance, and diagnostic measures used by the IRS units (LMSB Division, Office of Appeals, and Office of Chief Counsel) in the administration of transfer pricing.

III. Reviewed the decline in personnel resources available to conduct transfer pricing examinations.

IV. Determined the effects of the current trends in the administration of international transfer pricing.

A. Obtained the time it takes to complete an APA and a post-filing transfer pricing examination.

B. Obtained estimates of the cost of transfer pricing documentation on taxpayers.

[2] I.R.C. § 6662 (2003).

C. Determined the time and costs associated with the APA Program and the Post-Filing Examination Program for FY 2002.

Appendix II

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Appendix III

Report Distribution List

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- Chief, Appeals AP

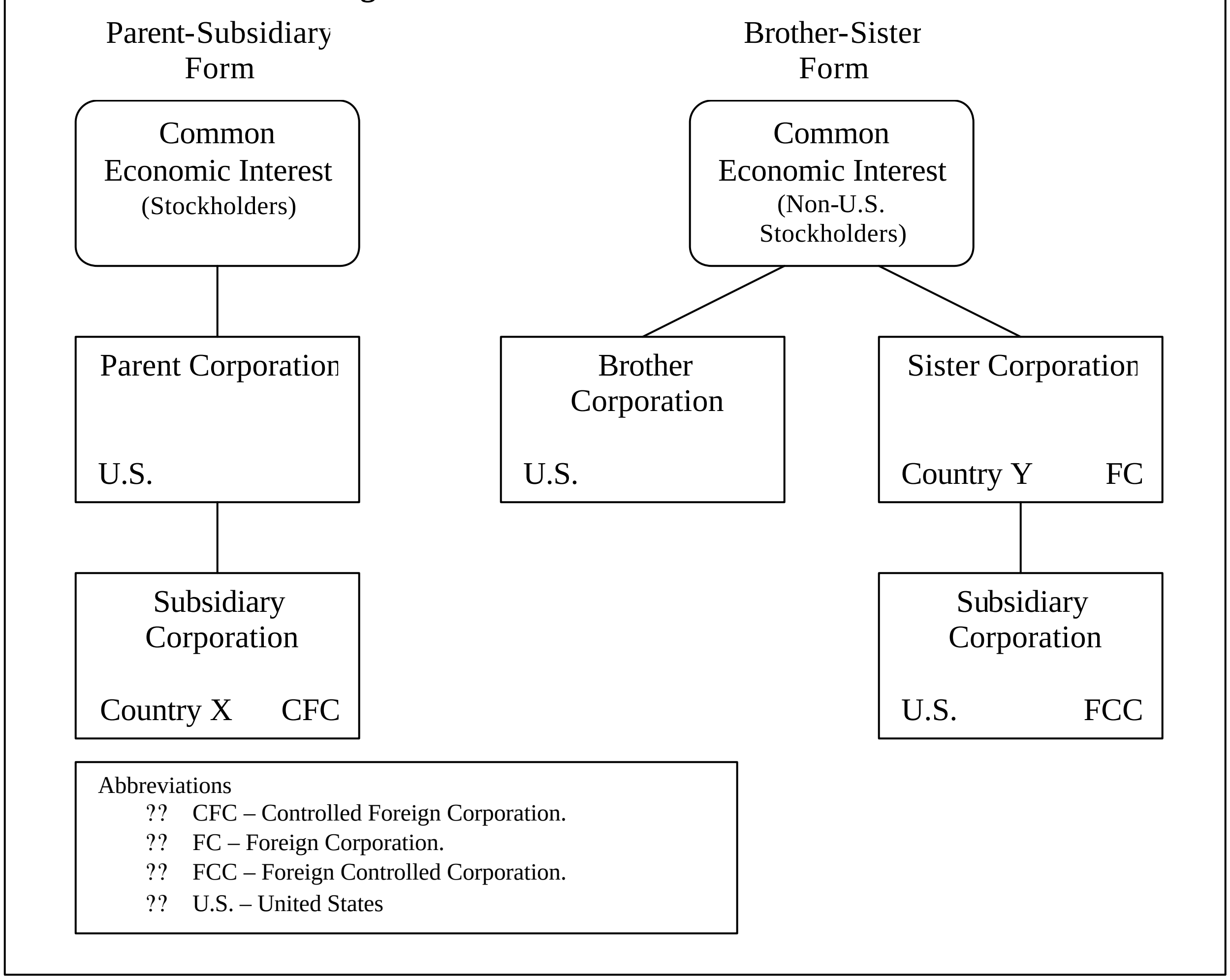
Appendix IV

Important Tax Concepts

Concept of Related Entities

Related entities in the context of transfer pricing are entities that are controlled by a common economic interest directly or indirectly. These entities may take the form of corporations, partnerships, or some other business formation. The common economic interest may be an individual, a group of individuals such as shareholders, a corporation, partnership, or some other business formation. Two of the most common forms of related entities are the parent-subsidiary form and the brother-sister form. See illustration in Figure 1.

Figure 1: Common Forms of Related Entities



Source: The Treasury Inspector General for Tax Administration.

In the parent-subsidiary form as illustrated, the common economic interest are the stockholders that own the United States (U.S.) parent corporation that directly controls the subsidiary corporation in Country X. The subsidiary corporation in this case is a Controlled Foreign Corporation (CFC). The stockholders of the U.S. parent corporation may be an individual, group of individuals, other corporations, partnerships, trusts, estates, or a combination. The U.S. parent corporation would file U.S. Corporation Income Tax Return (Form 1120).

In the brother-sister form as illustrated, the common economic interest of non-U.S. stockholders may be an individual, group of individuals, corporations, partnerships, or some other business formation that controls two corporations directly. The brother corporation is one incorporated in the U.S. The sister corporation is one incorporated outside the U.S and is therefore a Foreign Corporation (FC) that is taxable by the U.S. only on its effectively connected U.S. income, while the brother corporation is taxable on its worldwide income. The sister corporation, an FC, owns and controls a subsidiary, a U.S. domestic corporation known as a Foreign Controlled Corporation. The two U.S. corporations, the brother and the U.S.-based subsidiary, would file Form 1120. The FC, the sister corporation, would be required to file only if it had effectively connected U.S. income; it would file Form 1120F.

Concept of Control

Control in the context of transfer pricing is *de facto* or effective control and can be either direct or indirect. The Internal Revenue Code requires that the entities in question be owned by the same economic interest. The regulations further expand the term control to include any kind of control (i.e., direct or indirect), whether legally enforceable, and however exercisable or exercised. It is the reality of control which is decisive, not its form or the mode of its exercise.[1] For purposes of this meaning of control, one must differentiate between statutory control and *de facto* control.

Statutory control as it relates to corporations in general means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of all classes of stock.[2] For partnerships, control means owning directly or indirectly more than 50 percent of the capital interest or the profits interest.[3]

De facto control has been defined in two court decisions and takes precedence over statutory control. In B. Forman Co., Inc., the Second Circuit reversed the U.S. Tax Court decision that 50 percent ownership of a corporation by 2 unrelated partners was not control. In the decision, the Second Circuit held that the two partners were a *de facto* partnership or joint venture working in concert in making loans without interest to a corporation.[4] In another case, the Fifth Circuit upheld an allocation of income among four organizations, noting that it was immaterial that the

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[1] Treas. Reg. § 1.482-1(i)(4) (2003).
[2] I.R.C. §§ 269(a) and 304(c) (2003).
[3] I.R.C. § 707(b) (2003).
[4] 453 F.2d 1144 (2d Cir. 1972).

ownership of stock and partnership interests were not identical persons at the same time. Control could be inferred from the actions of the parties.[5]

The regulations state that a presumption of control arises if income or deductions have been arbitrarily shifted. The taxpayer is thus placed in the position of proving that, if the mechanical standards of statutory control are not satisfied, the *de facto* control also does not exist.[6]

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[5] 17202 F.2d 873 (CA-5, 1953).
[6] Treas. Reg. § 1.482-1(i)(4) (2003).

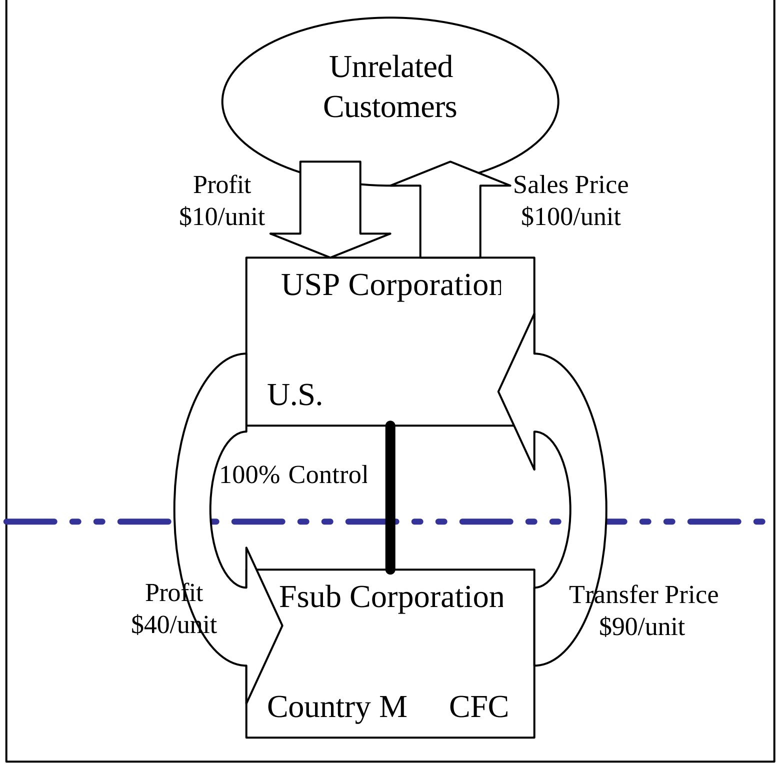
Appendix V

A Simple Illustration of How Transfer Pricing Can Be Used to Improperly Shift Income and Reduce Taxes

To establish transfer prices between related entities, the "arm's length" standard has been developed. The goal of this approach is to distribute income in the same way that the market would distribute income; therefore, related parties should earn the same return that unrelated parties would earn under similar circumstances. This approach is implemented through separate accounting in which an individual transfer price is determined for each transaction.

Figure 1 and the example that follows illustrate one method of how transfer pricing can be used to shift income and erode the United States (U.S.) tax base.

Figure 1: A Simple Example of an Abusive Transfer Pricing Transaction



Source: The Treasury Inspector General for Tax Administration (TIGTA).

Fsub Corporation is located in Country M, a country not contiguous to the U.S., and is a wholly owned foreign subsidiary (Controlled Foreign Corporation, CFC) of a U.S. corporation, USP Corporation. Fsub Corporation manufactures Product X, an unbranded widget, for a cost of $50 a unit, that it sells at a transfer price of $90 a unit to USP Corporation. USP Corporation then sells Product X to unrelated customers at the U.S. market price of $100 a unit. Unrelated and independent companies A, B, C, D, and E, also located in Country M, sell an unbranded widget similar to Product X for the market price of $55. The corporate tax rates in the U.S. and in Country M are 35 percent and 10 percent, respectively. In 200X, USP Corporation imported and sold 10,000 units of Product X. (See Table 1 for details of computations.)

Based on this scenario and assuming for purposes of the example that gross profit is equal to taxable income, USP Corporation would underreport its worldwide income tax liability by $87,500 ($162,500 – $75,000) by shifting $350,000 of taxable income to its controlled foreign subsidiary, Fsub Corporation, by using a transfer price of $90 per unit instead of the market price of $55 per unit. USP Corporation would underreport its U.S. tax liability by $122,500 ($157,500 – $35,000) and Fsub Corporation would overreport its Country M Tax Liability by $35,000 ($40,000 – $5,000).

Table 1: Example of Income Shifting Using Transfer Pricing

Transfer Price at $90/unit

Corporation	USP	Fsub	
Country	U.S.	Country M	Worldwide
Sales	1,000,000	900,000	1,000,000
Cost of Goods Sold	900,000	500,000	500,000
Gross Profit/Taxable Inc	100,000	400,000	500,000
Tax Rate	35%	10%	
Tax Liability	35,000	40,000	75,000

Transfer Price at Market Rate of $55/unit

Corporation	USP	Fsub	
Country	U.S.	Country M	Worldwide
Sales	1,000,000	550,000	1,000,000
Cost of Goods Sold	550,000	500,000	500,000
Gross Profit/Taxable Inc	450,000	50,000	500,000
Tax Rate	35%	10%	
Tax Liability	157,500	5,000	162,500

Source: The TIGTA.

If the example above was examined and an Internal Revenue Code Section 482 adjustment made to the taxable income of the members of the controlled group, there would be additional side effects of double taxation on the allocated amounts, changes in the amount of allowable foreign tax credit, and severe penalties.

Appendix VI

Historical Information on International Transfer Pricing and the "Arm's Length" Standard

The antecedents of Section (§) 482 predate the Internal Revenue Code (I.R.C.). The history of I.R.C. § 482[1] was briefly discussed in *A Study of Intercompany Pricing*, dated October 1988, that is commonly referred to as the "White Paper." Prepared by the Department of the Treasury's Office of International Tax Counsel and Office of Tax Analysis, and the Internal Revenue Service's (IRS) Office of Assistant Commissioner (International) and Office of Associate Chief Counsel (International), the paper describes that the IRS Commissioner was generally authorized to allocate income and deductions among affiliated corporations in 1917. The earliest direct predecessor of I.R.C. § 482 dates to 1921, when legislation went beyond the authority to require consolidated accounts and authorized the Commissioner to prepare consolidated returns for commonly controlled trades or businesses to compute their "correct" tax liability. This legislation was passed partly because possession corporations,[2] ineligible to file consolidated returns with their domestic affiliates, offered opportunities for tax avoidance. As early as 1921, the Congress perceived the potential for abuse among related taxpayers engaged in multinational transactions.

In the 1928 Revenue Act, the Congress removed the provision from the expiring consolidated return provisions and significantly expanded it as § 45, the predecessor to the current I.R.C. § 482. The provision gave the Commissioner the authority to make adjustments expressly predicated on the duty to prevent tax avoidance and to ensure the clear reflection of the income of related parties.

For many years prior to the 1960s, the small number of United States (U.S.) companies with multinational affiliates meant that I.R.C. § 482 had little impact in the international context. Regulations issued in 1935 remained substantially unchanged until 1968. These regulations set forth the "arm's length" standard as the fundamental principle underlying I.R.C. § 482, stating "The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer."[3] However, the regulations did not mandate any particular allocation method.

The case law interpreting I.R.C. § 482 and its predecessors took a broad approach. The concepts of "evasion of taxes" and "clear reflection of income" were developed into far-reaching weapons

[1] I.R.C. § 482 (2003).
[2] Possession corporations are corporations located in the United States (U.S.) overseas possessions of the Commonwealth of Puerto Rico, Guam, American Samoa, Wake Island, Midway Island, Palmyra, Johnston Island, Jarvis Island, Kingman Reef, Howland Island, Baker Island, Commonwealth of the Northern Mariana Islands, and the U.S. Virgin Islands.
[3] Treas. Reg. 86, § 45-1(b) (1935).

to attack a variety of tax abuses. The courts applied a number of different standards for determining when transactions were conducted at arm's length. Transactions were scrutinized to determine if related parties received full, fair value; a fair and reasonable price; or a fair price including a reasonable profit.

In 1961, the Department of the Treasury recommended that significant changes be made in the taxation of U.S. enterprises with foreign affiliates. In particular, the Department of the Treasury contended that I.R.C. § 482 was not effectively protecting the U.S. taxing jurisdiction. However, the Congress, in the Conference Committee reports to the 1962 Revenue Bill, thought otherwise:

> *The conferees on the part of both the House and the Senate believe that the objectives of Section 6 of the bill as passed by the House can be accomplished by amendment of the regulations under present Section 482. Section 482 already contains broad authority to the Secretary of the Treasury or his delegate to allocate income and deductions. It is believed that the Treasury should explore the possibility of developing and promulgating regulations under this authority which would provide additional guidelines and formulas for the allocation of income and deductions in cases involving foreign income.*[4]

The result was that the Department of the Treasury promulgated new I.R.C. § 482 regulations that were issued in final form in 1968. These regulations were extensively revised and updated again in 1994. The Department of the Treasury is currently working on providing additional I.R.C. § 482 guidance in the areas of cross-border services and cost sharing along with the recently issued regulations on stock option compensation.

[4] H.R. Rep. No. 2508, 87th Cong., 2d Sess. 18-19 (1962).

Appendix VII

Internal Revenue Service Initiatives Currently Underway to Help Improve Voluntary Compliance and the Administration of the Transfer Pricing Regulations

In Fiscal Year (FY) 2002, the Advance Pricing Agreement (APA) Program opened its second West Coast office in Laguna Niguel, California (south of Los Angeles), to complement its Northern California office in San Francisco and to better serve taxpayers. The APA Program had determined that approximately 25 percent of the APA Program case load comes from taxpayers west of the Mississippi River, with the majority in California. The APA Program determined that having western cases served from California would benefit both the taxpayers and the APA Program staff by reducing travel time, costs, and time zone complications, and by having closer relationships with western taxpayers and taxpayer organizations.

For similar reasons, the Office of Director, International, Large and Mid-Size (LMSB) Division, opened a second West Coast Tax Treaty office in El Segundo, California, to provide service on APA Program and Competent Authority cases. The staff of the Tax Treaty Division was increased by four tax treaty analysts in the West Coast office and four in the Washington, D.C., office in FY 2002.

Transfer pricing is a key focus of the LMSB Division's Globalization Strategic Initiative. The LMSB Division's *Strategy and Program Plan FY 2003-2004*, dated September 2002, describes several initiatives underway, related to transfer pricing administration, due to concerns about the movement of business profits and highly appreciated assets offshore.

One initiative is to evaluate compliance with the transfer pricing regulations, including issues emerging from application of the cost-sharing provision, and to develop appropriate strategies for addressing issues identified. Among the measures associated with the initiative are the percentage of open Coordinated Industry Cases (CIC) with time planned for transfer pricing and the percentage of CICs with pricing adjustments sent to the Internal Revenue Code (I.R.C.) Section (§) 6662(e) Penalty Screening Committee.

A second initiative is to support the Outside Expert Program that is occasionally used to administer the transfer pricing regulations. The Outside Expert Program is extremely critical to the development and defense of tax issues that are subject to litigation.

A third initiative is to provide training to agents and managers in the new Limited Issue Focused Examination model, as well as a new risk assessment analysis tool. This model, along with the examination standards and quality criteria, will allow agents and managers to focus on the most significant issues. The new risk assessment analysis tool balances the development of new issues against cycle time considerations. The new risk assessment training will include the new currency definition, criteria, risk assessment of employment taxes, and transfer pricing issues.

In addition to the initiatives mentioned in the *Strategy and Program Plan FY 2003-2004*, the LMSB Division's Economist Program, consisting of approximately 80 economists stationed in 18 key United States (U.S.) cities, has established national workgroups led by 1 of the 8 economist managers that are focusing on establishing consistency in the development of transfer pricing issues across the country. The economists in the Program are primarily located in proximity to both major Internal Revenue Service (IRS) International Examiner group concentrations and the U.S. headquarters of Multinational Enterprises (MNE). The Economist Program supplies economists that are experts in the field of transfer pricing and the "arm's length" principle. Nearly all of these economists hold a graduate degree and about 60 percent hold doctorates. The Economist Program, which is part of the Field Specialist Program, is also participating in an initiative with the Office of Appeals. According to officials, experienced economists will be reassigned to the Office of Appeals and will receive appeals resolution training as Appeals Economists to maintain the independence of the Office of Appeals.

The LMSB Division, the Office of Chief Counsel, and the Department of the Treasury continue to work on three significant regulation projects addressing transfer pricing issues. These projects include transfer pricing regulations addressing cross-border services and cost sharing, along with the recently issued regulations on stock option compensation.

The LMSB Division's Director, International, completed a study entitled *Effectiveness of Internal Revenue Code Section 6662(e)*, dated December 2001. This study was a response to a request by the Senate Committee on Appropriations that had expressed concern about the effectiveness of legislative changes affecting administration of I.R.C. § 482.[1] The Committee asked the IRS to provide information on three specific areas of interest:

* Whether taxpayers are preparing contemporaneous transfer pricing documentation as anticipated by I.R.C. § 6662(e).[2]
* The quality of the documentation.
* The utility of such documentation to the IRS in enforcing I.R.C. § 482.

The study found that most taxpayers prepare documentation for a substantial portion of controlled transactions, and taxpayers that prepare documentation for fewer than all transactions generally do so based on a cost-benefit analysis. The study also indicated that most taxpayers made substantial efforts to prepare documentation, particularly for controlled transactions deemed to have the greatest potential for scrutiny under I.R.C. § 482. The quality of documentation in individual cases varied widely. IRS examination teams surveyed as part of the study concluded that the documentation was very useful in the examination of transfer pricing issues by allowing early identification of key issues.

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1 I.R.C. § 482 (2003).
2 I.R.C. § 6662 (2003).

On January 22, 2003, the LMSB Division issued a memorandum to all its executives, managers, and agents instructing them to begin requesting contemporaneous transfer pricing information pursuant to I.R.C. § 6662(e) when opening cases with controlled transactions. The memorandum was effective immediately. The proper application of the procedures in this memorandum should permit the International Examiners and Economists to begin and complete their risk assessment analysis of transfer pricing issues on the returns in the case early in the examination, so that they can make a decision as to whether further examination of the transfer pricing issues is warranted.

On March 12, 2003, the IRS announced an agreement of the members of the Pacific Association of Tax Administrators (PATA).[3] The members agreed on principles under which MNE taxpayers can prepare one set of documentation that will meet the transfer pricing documentation provisions of each PATA member country, eliminating the need to prepare separate documentation for each country. The PATA Documentation Package is intended to reduce taxpayer burden and provide certainty that an otherwise applicable transfer pricing documentation-related penalty will not be imposed if documentation is maintained and submitted in accordance with the Package.

The PATA Documentation Package is voluntary in nature and does not preclude PATA member tax administrations from making transfer pricing adjustments and assessing any interest due on those adjustments. The Package is consistent with the general principles outlined in Chapter V of the Organization for Economic Cooperation and Development's (OECD)[4] *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (dated July 1995).

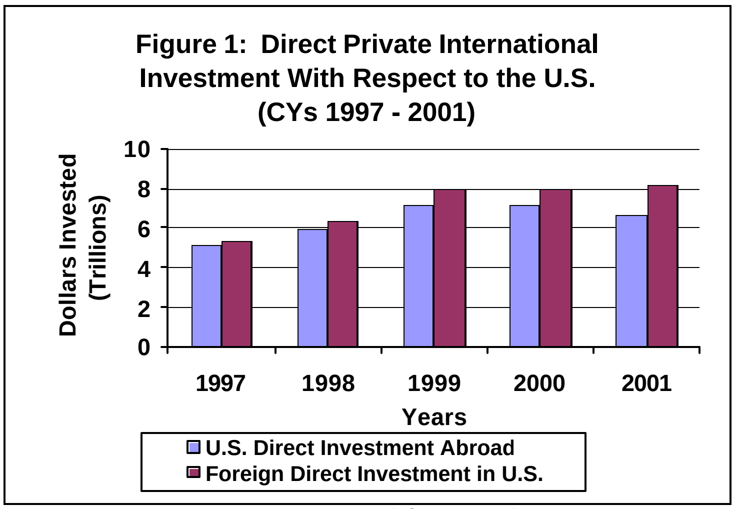
[3] The PATA is an intergovernmental tax organization whose members include Australia, Canada, Japan, and the U.S.

[4] The OECD groups 30 member countries (and the European Communities) that share a commitment to democratic government and the market economy. Its work covers economic and social issues from macroeconomics to trade, education, development, and science and innovation. Its members are Australia, Austria, Belgium, Canada, Czech Republic, Denmark, European Communities, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Republic of Korea, Luxembourg, Mexico, The Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom, and the U.S.

Appendix VIII

Increasing Globalization Leads to an Increasing Number of Controlled Transactions

The Department of Commerce, Bureau of Economic Analysis (BEA) reports that, for Calendar Years (CY) 1997 through 2001, direct private United States (U.S.) investment overseas increased 29 percent, from $5.158 trillion to $6.647 trillion.[1] During the same period, direct private foreign investment in the U.S grew at an even greater rate, 53 percent, from $5.341 trillion to $8.150 trillion (see Figure 1).[2] Between CYs 1998 and 2001, U.S. trade also increased. U.S. imports grew from $908 billion to $1.133 trillion, up 25 percent, and U.S exports increased from $680 billion to $731 billion, up over 7 percent.[3]



Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of U.S. Department of Commerce, BEA data on International Investment Position of the U.S. at Yearend, 1976-2001.[4]

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[1] U.S. direct investment abroad (USDIA) is defined as the ownership or control, directly or indirectly, by 1 U.S. person of 10 percent or more of the voting securities of an incorporated foreign business enterprise or the equivalent interest in an unincorporated foreign business enterprise. *International Investment Position of the U.S. at Yearend, 1976-2001*, U.S. Department of Commerce, BEA. www.bea.gov

[2] Foreign direct investment in the U.S. (FDIUS) is defined as the ownership or control, directly or indirectly, by 1 foreign person of 10 percent or more of the voting securities of an incorporated U.S. business enterprise or the equivalent interest in an unincorporated U.S business enterprise. *International Investment Position of the U.S. at Yearend, 1976-2001*, U.S. Department of Commerce, BEA. www.bea.gov .

[3] U.S. Department of Commerce, Bureau of the Census, *U.S. Goods Trade: Imports and Exports by Related Parties;* 1998 and 2001. www.census.gov/foreign trade

[4] U.S. Department of Commerce, BEA, *International Investment Position of the U.S. at Yearend, 1976-2001*. www.bea.gov

The increasing globalization of the economy evidenced by the increasing amount of private U.S. investment abroad and private foreign investment in the U.S., as well as the increasing amount of U.S. trade, directly affects the volume and amount of controlled transactions among Multinational Enterprise (MNE) groups.[5] These controlled transactions are required to be reported to the Internal Revenue Service (IRS) at the time the taxpayer's U.S. income tax return is filed.

The Information Return of U.S. Persons With Respect To Certain Foreign Corporations (Form 5471) is used by U.S. citizens and residents who are officers, directors, or 10 percent shareholders in certain foreign corporations. Schedule M is used to report a summary of transactions between the Controlled Foreign Corporation (CFC)[6] and the shareholder or other related entities grouped by category. One of the consequences of the increase in U.S. direct foreign investment abroad is the increase in the number of Forms 5471 with Schedule M filed by U.S. MNE groups. The number of Forms 5471 with Schedule M grew 42 percent, from 71,897 in Tax Year (TY) 1996 to 102,124 in TY 2000. While the growth in the number of return filings is impressive, the number of U.S. entities filing those returns grew more modestly. The U.S. entities filing a Form 5471 with Schedule M grew 27 percent, from 11,408 entities in TY 1996 to 14,461 in TY 2000 (see Figure 2). One reason for the disparity between filings and entities was explained in a recent planning document from the Large and Mid-Size Business Division. 3d---
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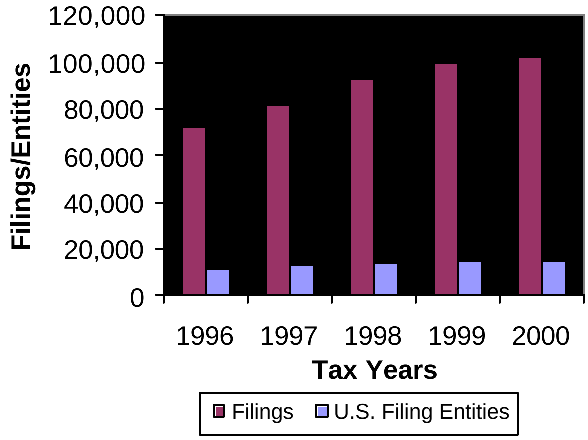
[5] The Internal Revenue Service uses different reporting thresholds from those used by the BEA, with regard to the reporting of related entities. The result is that the population of Information Returns of U.S. Persons With Respect To Certain Foreign Corporations (Form 5471) is a subset of the population defined by the USDIA, and the Information Returns of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (Form 5472) is a subset of the population defined by the FDIUS. In contrast, the Internal Revenue Code section 482 definition of control is far more encompassing and includes more transactions than just the trade in goods reported by the Bureau of the Census. The Bureau of the Census defines related party imports as "transactions between parties with various types of relationships including 'any person directly or indirectly, owning, controlling or holding power to vote, 6 percent of the outstanding voting stock or share of any organization'" and related party exports as "one between a U.S. exporter and a foreign consignee, where either party owns, directly or indirectly, 10 percent or more of the other party."

[6] A CFC is a corporation incorporated outside the U.S. that is controlled by a U.S. entity or entities, directly or indirectly.

Figure 2: Form 5471 Schedule M Returns With Summary of Controlled Transactions

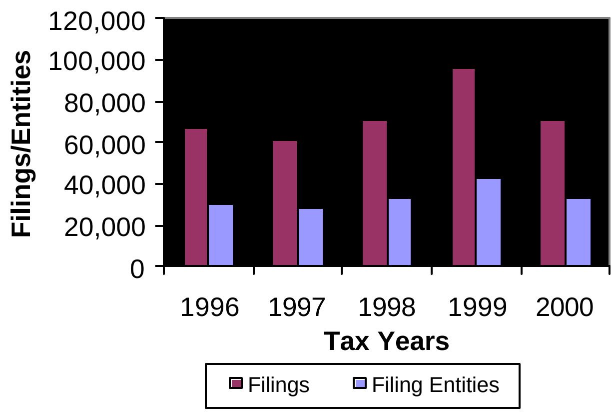


Source: TIGTA analysis of Forms 5471 from the Foreign Information System (FIS).

The Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (Form 5472) is filed by a 25 percent or more foreign-owned U.S. corporation[7] or a foreign corporation with reportable transactions. One of the results of the increase in foreign direct investment into the U.S. is the increase in the number of Forms 5472 filed by foreign MNE groups. Form 5472 filings grew 5.5 percent, from 67,633 in TY 1996 to 71,352 in TY 2000, while the entities filing Forms 5472 grew nearly 7 percent, from 31,140 FCCs and Foreign Corporations (FC) in TY 1996 to 33,255 FCCs and FCs in TY 2000 (see Figure 3).

[7] The IRS identifies corporations with 25 percent or greater foreign ownership as potential Foreign Controlled Corporations (FCC) for internal processing. An FCC is a corporation incorporated in the U.S. that is controlled by a foreign entity or entities, directly or indirectly.

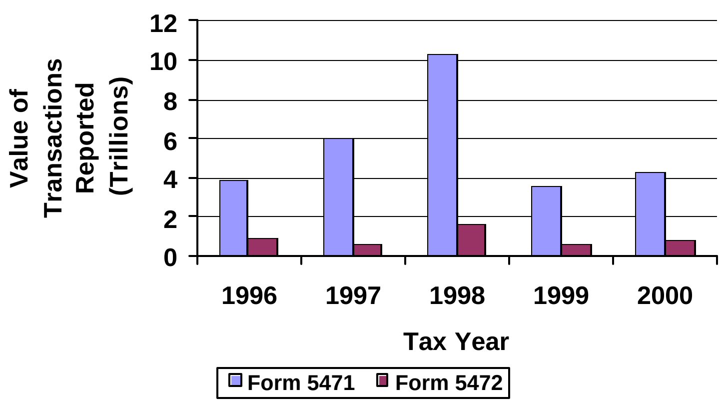
Figure 3: Form 5472 Returns With Summary of Controlled Transactions



Source: TIGTA analysis of Forms 5472 from the FIS.

The effect of this is that the value and complexity of the summary of controlled transactions reported on these information returns continues to grow. The value of the summary of controlled transactions reported on Forms 5471 with Schedule M grew 10 percent, from $3.9 trillion in TY 1996 to $4.3 trillion in TY 2000, while during the same period the value of the summary of controlled transactions reported on Forms 5472 by FCs and FCCs declined 16 percent, from $910 billion in TY 1996 to $761 billion in TY 2000 (see Figure 4).

Figure 4: Value of Summary of Controlled Transactions Reported (TYs 1996 - 2000)



Source: TIGTA analysis of Forms 5471 and 5472 from the FIS.

The Form 5471 Schedule M and Form 5472 information indicates that the potential population of MNEs with transfer pricing issues in the U.S. taxpayer population is far more concentrated than first indicated by the number of filings of Forms 5471 and Forms 5472. In TY 2000, only

47,716 business entities[8] filing U.S. income tax returns reported that they had controlled transactions. This represents 0.31 percent of the 15.5 million business returns filed (2.5 million corporate returns, 2.1 million partnership returns, 2.9 million S corporation returns, and 8 million sole proprietorship returns) for that year. However, the Form 5471 and Form 5472 information reports business receipts from related transactions in TY 1999 of $638 billion compared to the business receipts of $16.3 trillion reported for all corporation filings, or 4 percent.

[8] The number represents the sum of U.S. entities filing one or more Form 5471 reflecting cross-border transactions and the number of U.S. entities reflecting foreign ownership through the filing of one or more Form 5472. Some double counting may occur since some filers are required to file both Forms 5471 and 5472.

Appendix IX

Examination Trends in Transfer Pricing

The Internal Revenue Service (IRS) has historically attempted to assure voluntary compliance with the transfer pricing regulations by conducting post-filing examinations of income tax returns that contain controlled transactions. The primary objective in selecting returns for examination is to promote the highest degree of voluntary compliance on the part of taxpayers.[1] The consequences of this strategy were protracted disputes lasting years and limited access to information. To alleviate these problems, according to a 1999 IRS report,[2] the agency began implementing in 1992 a five-part strategy aimed at shifting the focus from after-the-fact examination and litigation of transfer pricing controversies, to encouragement of upfront taxpayer compliance and advance resolution of transfer pricing issues. The effect was to reduce the reliance on examinations as a tool for ensuring compliance of controlled taxpayers with the "arm's length" standard in determining their true taxable income on controlled transactions, while emphasizing upfront compliance tools such as guidance, Advance Pricing Agreements, and contemporaneous documentation.

The population of United States (U.S.) income tax returns with controlled transactions reported represents a small percentage of all business returns filed each year. For example, in Tax Year (TY) 1999, there were 15.1 million business income tax returns filed (2.5 million corporations, 2.8 million S corporations, 2 million partnerships, and 7.8 million sole proprietorships), but only 0.4 percent, or 59,432 U.S. business returns, reported containing controlled transactions based on the Information Return of U.S. Persons With Respect To Certain Foreign Corporations (Form 5471) or the Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (Form 5472)[3] (see Figure 1). Business entities filing U.S. income tax returns reported $3.598 trillion in controlled transactions on Forms 5471 and $657 billion on Forms 5472, for total controlled transactions of $4.255 trillion. This represented nearly 12 percent of the $36.859 trillion in transactions reported by corporations filing U.S. income tax returns in TY 1999.[4]

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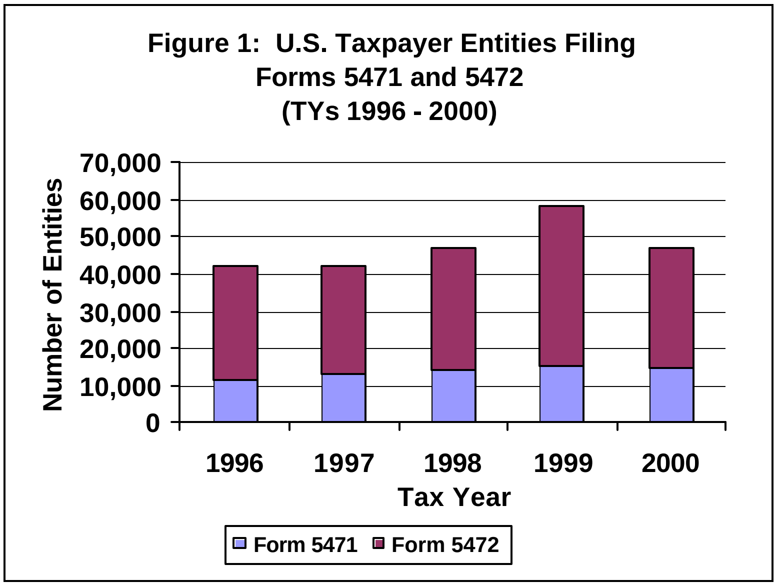
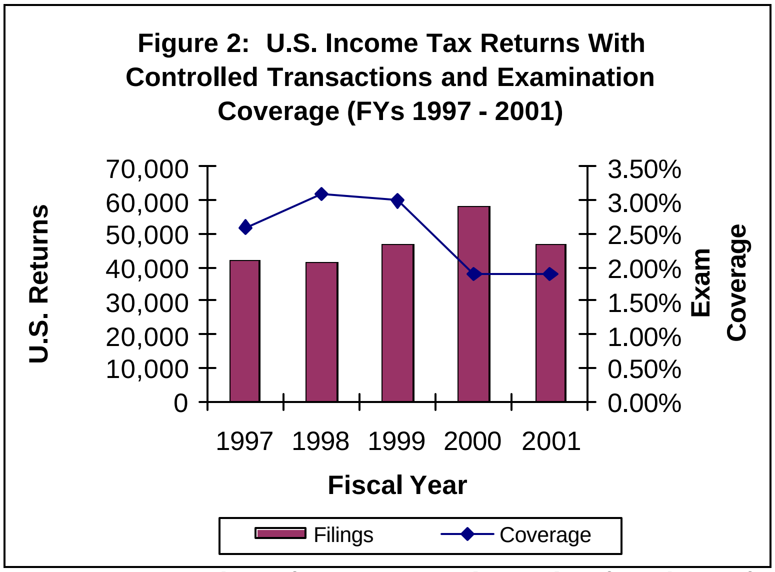
[1] Internal Revenue Manual 1.2.1 Part 4 P-4-21 (2000).
[2] U.S. Department of the Treasury, IRS, *Report on the Application and Administration of Section 482*; 1999.
[3] The 59,432 returns figure represents the sum of U.S. entities filing 1 or more Form 5471 reflecting cross-border transactions and the number of U.S. entities reflecting foreign ownership through the filing of 1 or more Form 5472. Some double counting may occur since some filers are required to file both Forms 5471 and 5472.
[4] For additional information, see Appendix VIII on how increasing globalization is leading to an increasing number of controlled transactions.



Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of Forms 5471 and 5472 from the Foreign Information System (FIS).

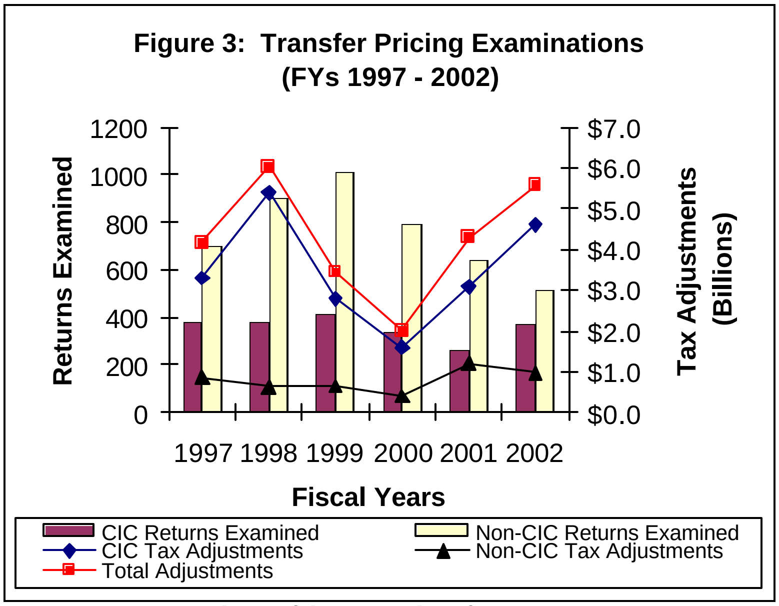
One measure of the IRS' overall Examination Program is the "Examination coverage rate," commonly known as the "audit rate," which is figured by dividing the number of returns examined by the total number of tax returns filed in the previous calendar year. Using this description, a rough estimate of the "Examination coverage rate" of U.S. entities filing U.S. income tax returns reporting controlled transactions can be developed. It shows the "Examination coverage rate" of returns with controlled transactions fell 27 percent between Fiscal Years (FY) 1997 and 2001, from 2.6 percent to 1.9 percent. During this same period, the overall number of U.S. income tax returns reporting controlled transactions grew 12 percent, from 42,548 to 47,716,[5] while the number of transfer pricing examinations fell 16 percent, from 1,083 to 906 returns examined (see Figure 2). In comparison, over the same period, the income tax return "Examination coverage rate" for all return categories fell 56 percent, from 1.27 percent of all income tax returns filed to 0.56 percent. In our discussions, the IRS also pointed out that during this period the IRS underwent a significant restructuring that had a broad impact on the assignment of work to Examination personnel and affected case closures.

[5] The U.S. entities required to file Forms 5471 or 5472 would also be required to file a U.S. income tax return.



Source: TIGTA analysis of Forms 5471 and 5472 data from the FIS for TYs 1996-2000 and the International Case Management System (ICMS) for FYs 1997-2001.

While the transfer pricing Examination coverage rate of controlled transactions declined, the amount of total transfer pricing adjustments made to taxable income by International Examiner (IE) Revenue Agents reported on the ICMS between FYs 1997 and 2002 peaked, then declined, then recovered, and then increased over its 1997 level. Total transfer pricing adjustments increased 34 percent in FY 2002 over the FY 1997 level, from $4.15 billion to $5.56 billion. Transfer pricing adjustments in the Coordinated Industry Case (CIC) Program paralleled the trend in total transfer pricing adjustments and increased 39 percent in FY 2002 over the FY 1997 level, from $3.3 billion to $4.6 billion. Transfer pricing adjustments in the Non-CIC Program declined from FYs 1997 to 2000 before recovering and increasing over the FY 1997 level in FY 2001. Transfer pricing adjustments in the Non-CIC Program increased 13 percent in FY 2002 over the FY 1997 level, from $861 million to $969 million (see Figure 3).



Source: TIGTA analysis of the ICMS data for FYs 1997 to 2002.

The examination of transfer pricing issues takes place in two components of the IRS field Examination Program by IEs in the Large and Mid-Size Business (LMSB) Division. The two components are:

* The CIC Program, a field Examination Program formerly known as the Coordinated Examination Program. It is operated by the LMSB Division and conducts examinations of the nation's largest corporations using teams of Income Tax Revenue Agents and Specialist Revenue Agents.

* The Non-CIC Program, a field Examination Program formerly known as the General Examination Program. It is operated by both the Small Business/Self-Employed and LMSB Divisions and conducts examinations of income tax returns using a single Income Tax Revenue Agent.

The CIC Program, in comparison to the Non-CIC Program, examines fewer returns with controlled transactions but accounted for over 81 percent of the proposed transfer pricing adjustments during FYs 1997 to 2002. Thirty-two percent of the transfer pricing examinations completed from FYs 1997 to 2002 involved large multinational corporations in the CIC Program. In a 1999 report,[6] the IRS estimated that transfer pricing examinations consumed about one-half the time of their staff of approximately 650 IEs.

While the return from transfer pricing adjustments appears high at the close of the examinations, the adjustments can be subsequently conceded in full or reduced through three methods that MNE taxpayers can use separately or in combination. MNE taxpayers can (1) challenge

[6] U.S. Department of the Treasury, IRS, *Report on the Application and Administration of Section 482*; 1999.

adjustments in the IRS Office of Appeals, (2) petition the U.S. Tax Court, or (3) pay the tax associated with the adjustments and sue for a refund in a U.S. District Court or in the Court of Federal Claims.

A U.S.-initiated transfer pricing adjustment may also be reduced as a result of a U.S. Competent Authority proceeding with a U.S treaty partner in an effort to eliminate double taxation pursuant to Revenue Procedure 2002-52.[7] For additional information on invoking Revenue Procedure 2002-52 as a means to secure relief from double taxation through the Mutual Agreement Procedure Process, see Appendix XI.

[7] Rev. Proc. 2002-52, IRB 2002-31, 242.

Appendix X

Advance Pricing Agreement Program Provides Avenue to Encourage Compliance

The Advance Pricing Agreement (APA) Program operated by the Associate Chief Counsel (International) is one of the methods used by the Internal Revenue Service (IRS) to encourage compliance with the transfer pricing regulations. The APA Program is a voluntary process. The Program is designed to resolve actual or potential transfer pricing disputes in a principled, cooperative manner, as an alternative to the traditional post-filing examination process.

The taxpayer submits an application for an APA together with a user fee as set forth in Revenue Procedure 96–53.[1] The process is broken down into five phases: (1) application, (2) due diligence, (3) analysis, (4) discussion and agreement, and (5) drafting and execution. An APA is a binding contract between the IRS and a taxpayer by which the IRS agrees not to seek a transfer pricing adjustment under Internal Revenue Code (I.R.C.) Section (§) 482[2] for a covered transaction if the taxpayer files its tax return for a covered year consistent with the agreed upon transfer pricing method.

An APA generally combines an agreement between a taxpayer and the IRS on an appropriate transfer pricing methodology for the transactions at issue with an agreement between the United States (U.S.) and one or more foreign tax authorities that the transfer pricing methodology is correct. With such a bilateral APA, the taxpayer is assured that the income associated by the covered transaction will not be subject to double taxation by the IRS and the foreign tax authority.

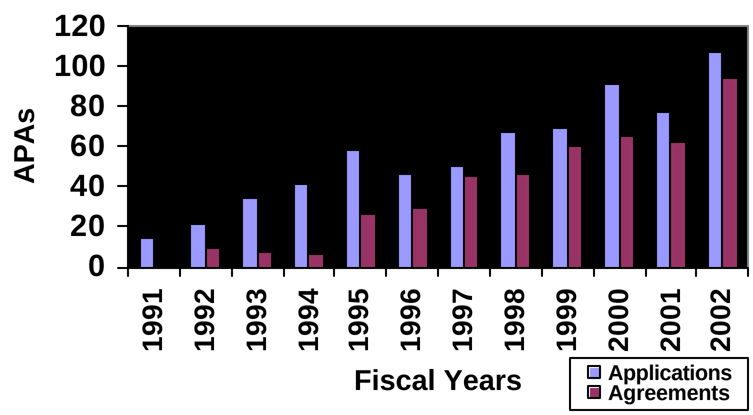
A unilateral APA is an agreement between a taxpayer and the IRS establishing an approved transfer pricing methodology for U.S. tax purposes only. A unilateral APA binds the taxpayer and the IRS but does not prevent foreign tax administrations from taking a different position on the appropriate transfer pricing methodology for a transaction.

APAs are negotiated with the taxpayer by an IRS team headed by an APA team leader. As of December 31, 2001, the APA Program had 22 team leaders, of whom 21 were attorneys and 1 was a former International Examiner (IE). The APA team generally includes an economist and an IE. In a bilateral case, a "competent authority analyst," who leads the discussions with the treaty partner, will be included. The APA team may also include Large and Mid-Size Business (LMSB) Division field counsel, other LMSB Examination personnel, and an Appeals Officer.

[1] Rev. Proc. 96-53 IRB 1996-49, 9.
[2] I.R.C. § 482 (2003).

The APA Program reported to the Congress[3] that it has received 676 applications over the life of the Program and has entered into 452 new and renewed APAs, consisting of 221 unilateral APAs (49 percent), 224 bilateral APAs (50 percent), and 7 multilateral APAs (1 percent) (see Figure 1). The Program has also reported that 5 APAs have been canceled and 80 APAs have been withdrawn during the life of the Program.

Figure 1: APA Applications and Agreements (FYs 1991 - 2002)



Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of APA Program Annual Reports to the Congress.

Most of the APAs made by the Program have been with foreign Multinational Enterprises (MNE) operating U.S. subsidiaries or branch offices in the U.S. The Program reported to the Congress that of 444 APAs, 253 APAs (57 percent) have been with foreign MNEs and 163 APAs (37 percent) have been with U.S. MNEs[4] (see Figure 2).

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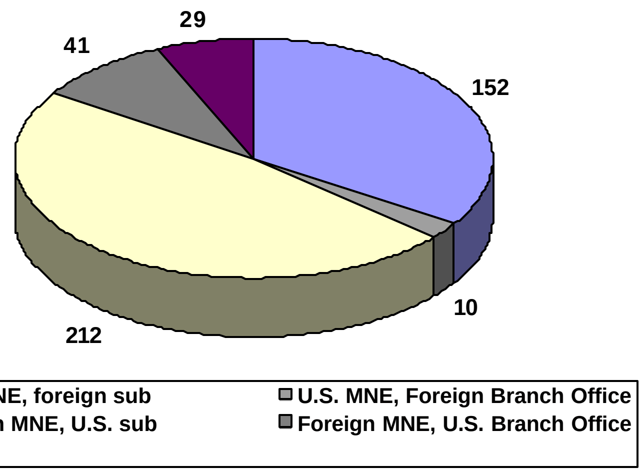
[3] Announcement 2000-35, IRB 2000-16, 922 – 947. Announcement 2001-32, IRB 2001-17, 1113 – 1136. Announcement 2002-40, IRB 2002-15, 747 – 777. Announcement 2003-19, IRB 2003-15, 723 – 749.

[4] The 163 APAs with U.S MNEs consist of 152 APAs between a U.S. parent and its foreign subsidiaries, 10 APAs between a U.S. company and its foreign branches, and 1 APA between a U.S. parent and its U.S. possession subsidiary.

Figure 2: Taxpayer Entities Contracting for APAs (1991 - 2002)



Source: TIGTA analysis of APA Program Annual Reports to the Congress.

The APA Program reports that the most frequently controlled transaction that is the subject of an APA is the sale of tangible property into the U.S. The most frequently applied transfer pricing methodology used by the APA Program is the Comparable Profits Method (CPM). The 2001 APA Program annual report describes the benefits of this method:

> *The CPM is frequently applied in APAs. This is because reliable public data on comparable business activities of independent companies may be more readily available than potential CUP [Comparable Uncontrolled Price] data and comparability of resources employed, functions, risks and other relevant considerations is more likely to exist than comparability of product. The CPM also tends to be less sensitive than other methods to differences in accounting practices between the tested party and comparable companies.… In addition, the degree of functional comparability required to obtain a reliable result under the CPM is generally less than required under the resale price or cost plus methods, because differences in functions performed often are reflected in operating expenses, and thus taxpayers performing different functions may have very different gross profit margins but earn similar levels of operating profit.*[5]

Figure 3 shows the frequency of the various transfer pricing methodologies used in the APA Program.

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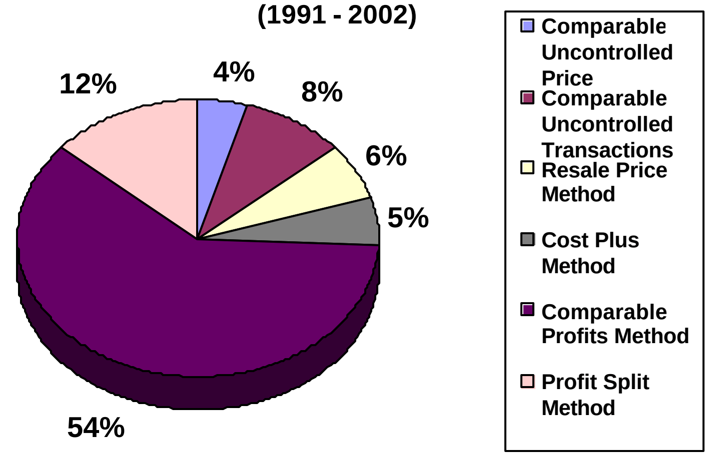
[5] Announcement 2002-40, IRB 2002-15, 760.

Figure 3: Transfer Pricing Methods Used for Tangible and Intangible Property (1991 - 2002)



Source: TIGTA analysis of APA Program Annual Reports to the Congress.

The heavy use of the CPM by the APA Program may be indicative of the methods being used by the taxpayers when filing their returns and also by the IRS when making an I.R.C. § 482 allocation during a transfer pricing dispute in a post-filing examination.

Appendix XI

Mutual Agreement Procedure Process

Taxpayers may obtain assistance from the United States (U.S.) Competent Authority under the provisions of an income, estate, or gift tax treaty to which the U.S. is a party by invoking Revenue Procedure 2002-52.[1] The Large and Mid-Size Business Division's Director, International, acts as the U.S. Competent Authority in administering the operating provisions of tax treaties and in interpreting and applying these treaties. The U.S. Competent Authority assists taxpayers with respect to matters covered in the Mutual Agreement Procedure (MAP) provisions of tax treaties in the manner specified in those provisions. A tax treaty generally permits taxpayers to request competent authority assistance when they consider that actions of the U.S., the treaty country, or both, result or will result in taxation that is contrary to the provisions of a treaty. There is no authority for the U.S. Competent Authority to provide relief from U.S. tax or to provide assistance due to taxation arising under the tax laws of the foreign country or the U.S., unless such authority is granted by a treaty.

If a taxpayer's request for competent authority assistance is accepted, the U.S. Competent Authority generally will consult with the appropriate foreign competent authority and attempt to reach an agreement that is acceptable to all parties. The U.S. Competent Authority may also initiate competent authority negotiations in any situation deemed necessary to protect U.S. interests. Such a situation may arise, for example, when a taxpayer fails to request competent authority assistance after agreeing to a U.S. or foreign tax assessment that is contrary to the provisions of an applicable tax treaty or for which correlative relief may be available. The failure of the taxpayer to request competent authority assistance or to take appropriate steps, as necessary to maintain availability of the remedy, may cause a denial of part or all of any foreign tax credits claimed.

A request for competent authority assistance may be filed at any time after an action results in taxation not in accordance with the provisions of the applicable treaty. In a case involving a U.S.-initiated adjustment of tax or income resulting from a tax examination, a request for competent authority assistance may be submitted as soon as practicable after the amount of the proposed adjustment is communicated in writing to the taxpayer on a Notice of Proposed Adjustment (Form 5701).

When a request for competent authority assistance is accepted with respect to a U.S.-initiated adjustment, the Internal Revenue Service (IRS) will postpone further administrative action with respect to the issues under competent authority consideration. However, the normal administrative procedures continue to apply to all other issues not under the U.S. Competent Authority consideration.

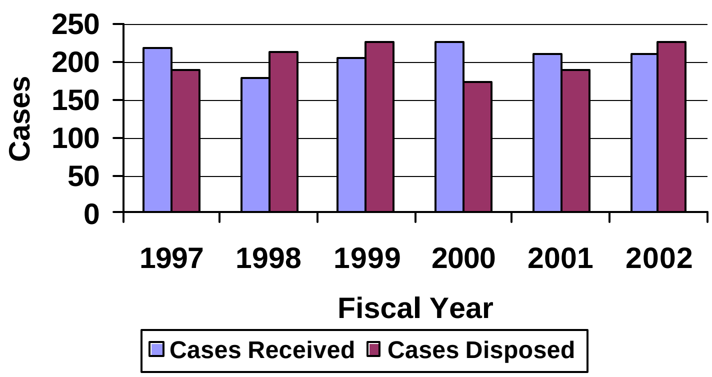
[1] Rev. Proc. 2002-52 IRB, 2002-31, 242.

Taxpayers who disagree with a proposed U.S. adjustment may either pursue their right of administrative review with the Office of Appeals before requesting competent authority assistance or request competent authority assistance immediately. The Office of Appeals' consideration of potential competent authority matters will be made without regard to other issues or considerations that do not involve potential competent authority matters. Taxpayers that are pursuing their rights with the Office of Appeals may contact the U.S. Competent Authority if they believe they have potential competent authority issues. If a taxpayer decides to make a competent authority request, it may choose to make a request pursuant to the Simultaneous Appeal procedures.

In Fiscal Year (FY) 1997, the U.S. Competent Authority received 218 cases for competent authority assistance with a tax treaty provision. In FY 2002, the U.S. Competent Authority received 212 cases, a decline of nearly 3 percent from the FY 1997 level. The number of cases received during this period ranged from a high of 228 in FY 2000 to a low of 178 cases in FY 1998.

The U.S. Competent Authority disposed of 228 cases in FY 2002, a 20 percent increase from the 1997 level of 190 cases. The disposition of cases ranged from a low of 175 cases in FY 2000 to a high of 228 cases in both FYs 1999 and 2002 (see Figure 1).

Figure 1: Cases Received and Disposed of by the Office of the U.S. Competent Authority (FYs 1997 - 2002)



Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of U.S. Competent Authority statistics data from the Director, International.

These cases included:

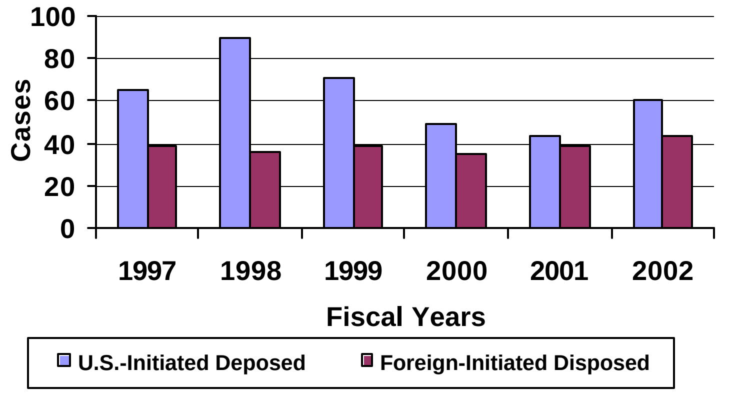
* Allocation cases where the taxpayer sought relief from double taxation due to transfer pricing adjustments under Internal Revenue Code (I.R.C.) Section (§) 482.[2]
* Advance Pricing Agreement (APA) cases where the taxpayer sought a bilateral or multilateral APA to eliminate potential double taxation on its proposed transfer pricing methodology.
* Nonallocation cases and limitation of benefits cases where the taxpayer sought competent authority to resolve issues of fiscal residence or to allow a competent authority to make a discretionary determination that a taxpayer is entitled to the benefits of a treaty under specific limitation on benefits provisions.

Allocation cases result when taxpayers request assistance under a tax treaty to relieve economic double taxation arising from an allocation under I.R.C. § 482 or an equivalent provision under the laws of a treaty country. With respect to a request for competent authority assistance involving allocation of income and deductions between a U.S. taxpayer and a related person, the U.S. Competent Authority and its counterpart in the other treaty country will be bound by the "arm's length" standard provided by the applicable provisions of the relevant treaty. The U.S. Competent Authority will also be guided by the "arm's length" standard consistent with the regulation under I.R.C. § 482 and the Organization of Economic Cooperation and Development's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (dated July 1995). When negotiating Mutual Agreements on the allocation of income and deductions, the U.S. Competent Authority will take into account all of the facts and circumstances of the particular case and the purpose of the treaty to avoid double taxation.

In FY 1997, the U.S. Competent Authority closed 104 allocation cases, or 55 percent of the 190 cases it disposed of, composed of 65 U.S.-initiated cases and 39 foreign-initiated cases. However, by FY 2002, the number of allocation cases closed remained at the same level of 104 cases, composed of 60 U.S.-initiated cases and 44 foreign-initiated cases. The allocation cases declined in percentage terms by 16 percent, to only 46 percent of the 228 cases closed by the U.S. Competent Authority (see Figure 2).

[2] I.R.C. § 482 (2003).

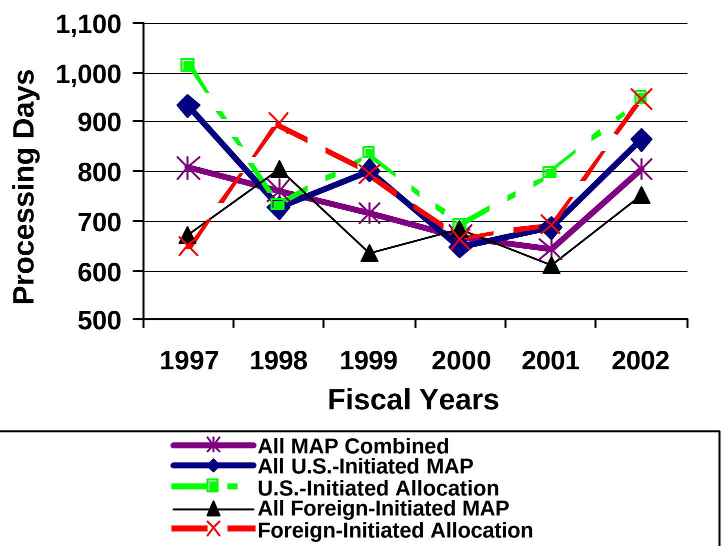
Figure 2: Allocation Cases Closed by the U.S. Competent Authority (FYs 1997- 2002)



Source: TIGTA analysis of U.S. Competent Authority statistics data from the Director, International.

Between FYs 1997 and 2002, the U.S. Competent Authority reported no clear trends with regard to the length of the MAP process. Depending upon the year, the length of the process averaged 679 days to 948 days (see Figure 3).

Figure 3: Average Processing Days on Closed Cases (FYs 1997- 2002)



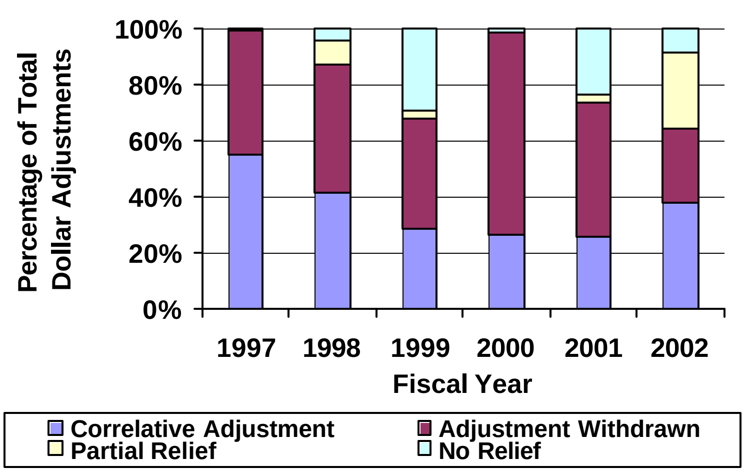
Source: TIGTA analysis of U.S. Competent Authority statistics data from the Director, International.

With respect to transfer pricing issues, the goal of the MAP process is the avoidance of double taxation or taxation not in accordance with the applicable treaty.

Figure 4 shows the percentage of the type of relief granted for the total adjustments closed by the U.S. Competent Authority for FYs 1997-2002. For example, in FY 2002:

* A correlative adjustment was provided in 38 percent of the adjustments closed by the U.S. Competent Authority, thus eliminating the potential for double taxation. In these cases, a corresponding decrease in income was provided by the non-initiating country.
* The adjustment was withdrawn by the initiating country in 27 percent of the adjustments, eliminating the potential for economic double taxation. In these cases, the U.S. Competent Authority determined that the proposed adjustments were either without merit, de minimis, or barred by statute.
* Partial relief was provided in 27 percent of the adjustments. In these cases, both countries retained taxing rights, and relief generally was provided through the allowance of foreign tax credits in one or both countries.
* No relief was provided in 9 percent of the adjustments. In these cases, the U.S. Competent Authority did not provide assistance.

Figure 4: Competent Authority Relief (FYs 1997- 2002)



Source: TIGTA analysis of U.S. Competent Authority statistics data from the Director, International.

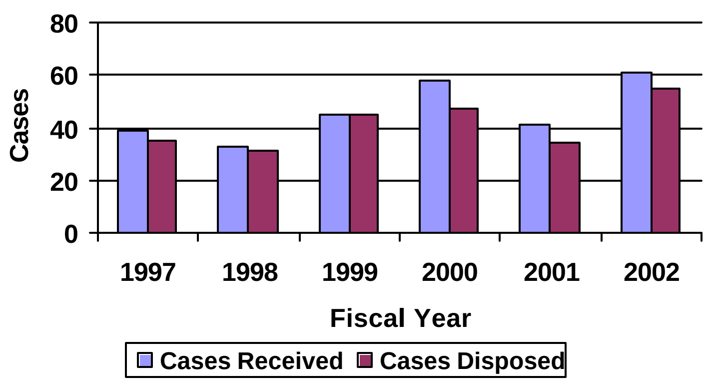
As previously discussed in Appendix X, the U.S. Competent Authority is also involved in the negotiation of bilateral APAs. A bilateral APA is a contract between a taxpayer and the IRS on an appropriate transfer pricing methodology for the transaction at issue, with an agreement between the U.S. and one or more foreign tax authorities that the transfer pricing methodology is correct. In a bilateral case, the discussions proceed in two parts and involve two IRS offices: the APA Program and the U.S Competent Authority. In the first part, the APA Program team will attempt to reach a consensus with the taxpayer regarding the position that the APA Program office recommends the U.S. Competent Authority take in negotiations with its treaty partner.

The APA Program and the U.S. Competent Authority report that APA Program negotiations are likely to proceed faster with the foreign competent authority if the taxpayer fully supports the recommended U.S. negotiating position. This recommended U.S. negotiating position is a paper drafted by the APA Program team leader and signed by the APA Program Director that provides the APA Program's view of the best transfer pricing method for the covered transaction, taking into account I.R.C. § 482 and the regulations thereunder, the relevant tax treaty, and the U.S. Competent Authority's experience with the treaty partner.

Once the APA Program completes the recommended U.S. negotiating position, the APA Program process shifts from the APA Program to the U.S. Competent Authority. The U.S. Competent Authority analyst assigned the APA takes the recommended U.S. negotiating position and prepares the final U.S. negotiating position, which is then transmitted to the foreign competent authority. The negotiations with the foreign competent authority are conducted by the U.S. Competent Authority analyst, most often in face-to-face negotiating sessions conducted periodically throughout the year.

Between FYs 1997 and 2002, the U.S. Competent Authority received requests for bilateral and multilateral APAs ranging from a low of 33 cases in FY 1998 to a high of 61 cases in FY 2002. The 61 cases received in FY 2002 were a 56 percent increase over the FY 1997 level of 39 cases received. During the same period, the U.S. Competent Authority completed Mutual Agreements on 55 cases in FY 2002, an increase of 57 percent over the FY 1997 level of 35 cases. During this period, bilateral APAs completed by the U.S. Competent Authority ranged from a low of 31 cases in FY 1998 to a high of 55 cases in FY 2002 (see Figure 5).

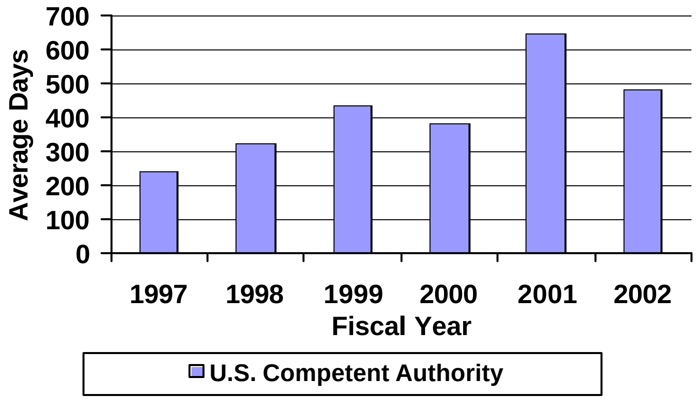
Figure 5: APAs Processed by the U.S. Competent Authority (FYs 1997 - 2002)



Source: TIGTA analysis of U.S. Competent Authority statistics data from the Director, International.

The U.S. Competent Authority tracks time on an APA case from the date a tax treaty analyst is assigned to a case to the date the final Mutual Agreement is concluded with a treaty partner or partners. Between FYs 1997 and 2002, the U.S. Competent Authority reported that it can take up to 484 days on average to secure a Mutual Agreement, depending upon the year a bilateral APA Program case was completed (see Figure 6).

Figure 6: Processing Time on APAs to Complete U.S. Competent Authority Negotiations (FYs 1997 - 2002)



Source: TIGTA analysis of U.S.Competent Authority statistics data from the Director, International.

Appendix XII

Internal Revenue Code Section 482

Sec. 482. Allocation of income and deductions among taxpayers. *In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.*[1]

[1] Internal Revenue Code Section 482 (2003).